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Background Paper

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CANADIAN COMPETITIVENESS: TWO RECENT STUDIES

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February 1992



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CANADIAN COMPETITIVENESS:
TWO RECENT STUDIES

INTRODUCTION

At the end of October 1991 two studies dealing with the competitiveness of the Canadian economy were released. The first (known as the Porter study) was financed in part with government money; the second (known as the Prosperity Initiative) consisted of two papers put out by federal government departments. In recent years there has been much interest in the faltering Canadian economy. Productivity growth has been weak since the mid-seventies, and since the mid-eighties Canadian unit labour costs have soared. Unemployment has been relatively high and steady. Given this economic background, a government view of the state of Canadian competitiveness is useful. This background paper deals with the two recent studies.

THE PORTER STUDY ON COMPETITIVENESS IN CANADA

On 24 October 1991 the Business Council on National Issues (BCNI) released the study *Canada at the Crossroads: The Reality of a New Competitive Environment*, by Harvard Professor Michael Porter. The study, which cost a \$1 million, was financed by the BCNI and the Government of Canada. Significantly, labour in Canada did not co-sponsor the study, and there is some question as to whether it will take an active part in future discussion of the report and the feasibility of implementing any of its recommendations.

This review provides a brief summary of the report, which is in many ways an extension of earlier work by Porter, especially *The Competitive Advantages of Nations*.⁽¹⁾ This book was probably the most reviewed business book of 1990; it now influences, directly or indirectly, positively or negatively, all work on competition in modern economies.

A. The Porter Model of Competitiveness

Today, companies have few secure niches. Companies can no longer sit back and enjoy the advantages of being the first to present a new product or the first to adopt a new technology. Technology changes rapidly. Firms around the world are constantly elbowing each other out of markets and searching for newer and newer sources of competitive advantage. In such a world industrial development obviously consists of more than building steel mills and putting up factories: industries must be able to sell what they produce -- now and in the foreseeable future.

No one, whether in business, government or labour, has ever been able to foretell the future, and in a rapidly changing world uncertainty is even greater. Traditional models often assume too readily that much information -- including future information -- is available, and these models occasionally leave government out of the analysis. What is needed is a model of the modern, globally competitive world that allows for less than perfect information and also for a government policy that influences the competitiveness of firms without becoming involved in the impossible game of attempting to pick winners among industries. Michael Porter has developed such a model.

For Porter, competitiveness is the key to a nation's prosperity and to any hope of increasing the average citizen's standard of living. For any firm, the bottom line of Porter's analysis is simple: innovate or perish. Porter's conclusion is based on an inductive approach; he studied successful manufacturing industries in several nations and

(1) Michael Porter, *The Competitive Advantage of Nations*, The Free Press, New York, 1990.

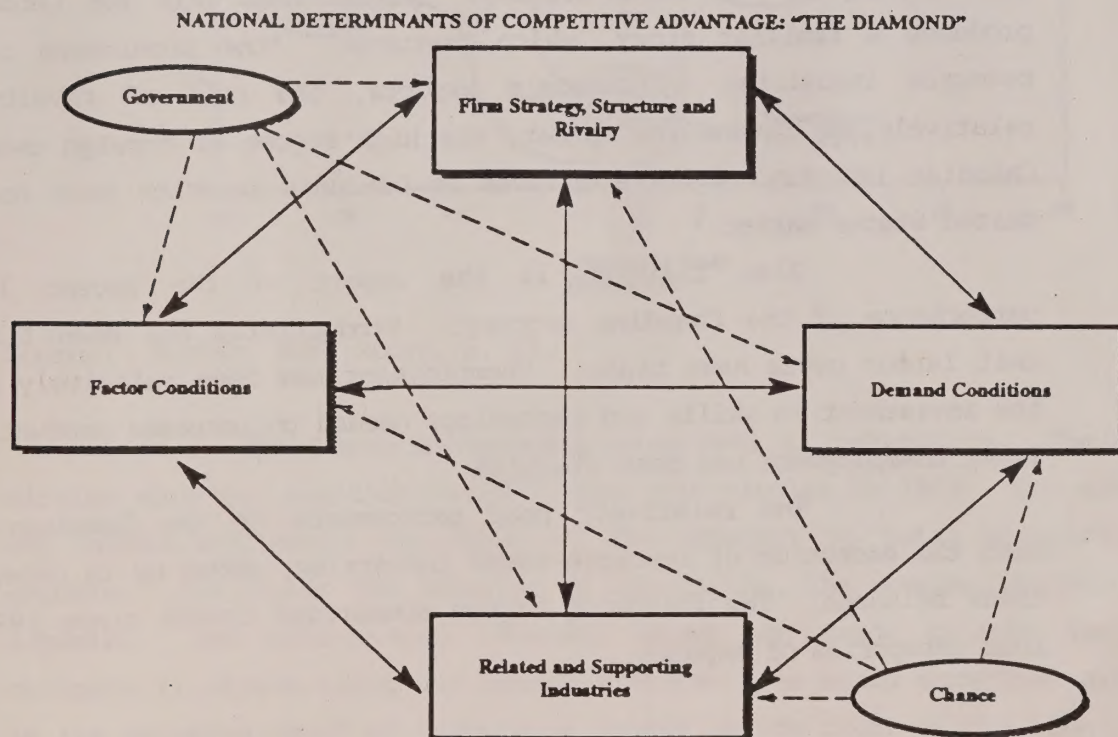


looked for common factors that could explain their success. (Because of its dependence on natural resources, Canada was not part of the original study.)

The ability of firms and industries to innovate and stay competitive depends, according to Porter, on four attributes. These attributes constitute what Porter labels the Diamond of National Competitive Advantage. They are shown in Figure 1:

FIGURE 1

CANADA AT THE CROSSROADS
The Reality of a New Competitive Environment



Source: Porter, BCNI Study, p. 25.

Domestic firms will innovate if rivalry at home is fierce. This innovation will enable them to be competitive internationally if they have domestic factors (such as skilled labour or the necessary transportation and communication infrastructure) to provide a potential comparative advantage; if domestic consumers are demanding enough to ensure that domestic products meet or exceed foreign requirements; and if supporting home industries are also innovative so production remains relatively efficient. Chance and government policy play indirect roles in the model. The diamond is an interdependent system; its weakest link determines its overall competitiveness.

B. Canada's Current Place in the World Economy

Before attempting to use the Porter model to improve any country's competitiveness, it is necessary to find out the current place of that country in the world economy. Porter does this for Canada -- and produces a familiar story, which features: "the prominence of natural resource industries in Canada's exports, the role of rivalry in the relatively small Canadian market, the high degree of foreign ownership of Canadian industry, and the effects of Canada's location next to the huge United States market."

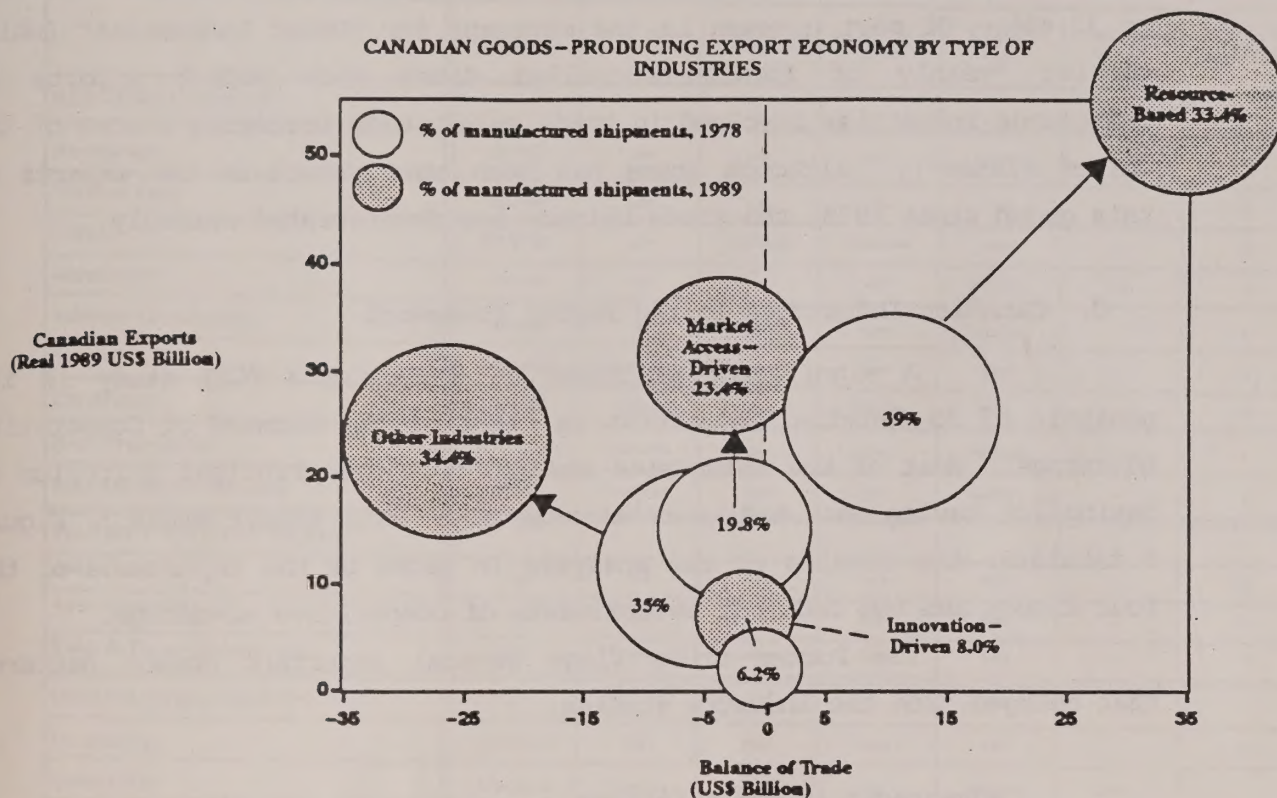
Also familiar is the report of the recent lacklustre performance of the Canadian economy. Productivity has been flat, while unit labour costs have risen. Unemployment has been relatively high, and the investment in skills and technology needed to increase productivity and lower unemployment has been sluggish.

The relatively poor performance of the Canadian economy, with the exception of resource-based industries, shows up in deteriorating trade balances. The following figure summarizes trends since 1978 in the four categories of exports.



FIGURE 2

CANADA AT THE CROSSROADS
The Reality of a New Competitive Environment



Source: Porter, BCNI Study, p. 21.

The figure condenses a great deal of information. The white circles show the position in 1978, the gray circles in 1989. The size of any circle represents the share of the category in total manufacturing exports; the higher the location of the circle, the greater the value of exports; the side-to-side movement shows the trade balance for the category (a circle along the dashed vertical line would show that exports in the category equalled imports, a circle to the right of the line shows exports greater than imports). The best movement would be to the upper right-hand corner with an increase in the size of the circle; such a movement would show that exports grew between 1978 and 1989, the trade

balance improved and the category was of growing importance in total manufacturing shipments. Unfortunately, none of the categories shows such a movement. The circle for resource-based industries has moved to the upper right corner, but the circle has shrunk (from 39% of total shipments to 33.4%). Of most concern is the movement for "Other Industries" (which consist "mainly of foreign-controlled firms with modest exports or indigenous industries involved in trade solely with bordering states of the United States"); although there has been some growth in the exports of this group since 1978, the trade balance has deteriorated markedly.

C. Canadian Industries in the Porter Framework

A significant contribution of Porter's BCNI study is its analysis of 25 Canadian industries in terms of the Diamond of Competitive Advantage. Most of the industries studied "met the principal criterion of having (or having once had) a relatively high world export share." Figure 3 tabulates the results of the analysis in terms of the importance of the four direct and two indirect determinants of competitive advantage.

The Porter study flags several important common patterns that emerged from the industry studies:

- advantages in basic factors,
- risk-averse, inward-looking, cost-based strategies,
- lack of intense Canadian rivalry,
- limited advanced and specialized factor creation,
- lack of cutting-edge home demand,
- weaknesses in related and supporting industries.

Every economic history of Canada emphasizes the wealth of this country's natural resources as a source of economic development. Those resources are indeed a source of Canada's prosperity, a determinant of current trade relationships and, according to Porter, a disincentive to moving beyond the factor-driven stage of development. By relying on past



FIGURE 3

CANADA AT THE CROSSROADS
The Reality of a New Competitive Environment

SOURCES OF INTERNATIONAL COMPETITIVENESS IN SELECTED CANADIAN INDUSTRIES

| INDUSTRY | FACTOR CONDITIONS | DEMAND CONDITIONS | RELATED AND SUPPORTING | STRATEGY, STRUCTURE & RIVALRY | ROLE OF GOVERNMENT | ROLE OF CHANGE | % SHARE OF WORLD EXPORTS 1988 |
|-----------------------------|-------------------|-------------------|------------------------|-------------------------------|--------------------|----------------|-------------------------------|
| RESOURCE-BASED | | | | | | | |
| Newsprint | (B) High | Low | Low | Low | Low | - | 30 |
| Market Pulp | (B) High | Low | Low | Low | Low | - | 33 |
| Nickel | (B&A) High | Low | Moderate | Moderate | High | - | 30 |
| Aluminum | (B) High | Low | Low | Low | Moderate | High | 18 |
| Atlantic Groundfish | (B) High | Low | Moderate | Low | Negative | - | 8 |
| Styrene | (B) High | Moderate | Moderate | Low | Low | - | 18 |
| Electricity | (B) High | Moderate | High | Moderate | High | - | 15 |
| Beef Processing | (B) Moderate | Moderate | Low | Low | Moderate | - | 1 |
| Manufactured Housing | (B) High | Moderate | Low | Low | Moderate | - | 5 |
| MARKET-ACCESS BASED | | | | | | | |
| Auto Parts | Low | Low | Low | Low | High | - | 10 |
| Auto Assembly | Low | Low | Low | Low | High | - | 10 |
| Pulp & Paper Equipment | Low | Low | Moderate | Low | Low | - | 11 |
| INNOVATION-DRIVEN | | | | | | | |
| Ice Skates | (A) Moderate | High | High | High | Low | - | 50 |
| Urban Rail | (A) Moderate | Moderate | Moderate | Low | Moderate | Moderate | 7 |
| Flight Simulators | (A) Moderate | Low | Low | Moderate | Low | - | 22 |
| Industrial Explosives | (B) Moderate | High | Moderate | Moderate | High | - | n/a |
| Commuter Aircraft | (A) Moderate | Moderate | Moderate | Low | Moderate | Moderate | 10 |
| Central Office Switches | (A) High | High | Moderate | High | Moderate | Moderate | 15 |
| Geophysical Contracting | (A) High | Moderate | High | High | High | - | 50 |
| Consulting Engineering | (A) Moderate | High | Low | High | High | - | n/a |
| Whisky | (B&A) Moderate | Low | Low | Moderate | Negative | High | 12 |
| Life Insurance | (A) Moderate | Moderate | Low | High | High | - | 10 |
| Human Biologicals | (A) Moderate | Low | Low | Low | Moderate | Moderate | n/a |
| OTHER | | | | | | | |
| Waste Management | (A) Moderate | Moderate | Low | Low | Low | Moderate | n/a |
| Radiation Therapy Equipment | (A) Moderate | Low | High | Low | High | - | 30 |

(B) Advantage stems from basic factor conditions

(A) Advantage stems from advanced factor conditions

Source: Porter, BCNI Study, p. 37.

strengths, Canada has not yet been forced to emphasize innovation; this limits rivalry, as does the relatively small size of the domestic market in Canada. Established firms pursue established business, and there is little incentive for them to move to advanced and non-established areas. Any diversity of products owes more to firms' search for protected and profitable markets than to their need to attract customers; in such circumstances, consumers do not become sophisticated buyers. There are certainly exceptions to this picture of the Canadian economy, but its patterns are easily recognizable.

Although elements of the patterns have been identified before, Porter's model ties them together. He emphasizes the six common patterns that relate to the direct determinants of competitive advantage. Of the two indirect determinants, chance -- especially in the form of our proximity to the U.S. and some U.S. legal decisions -- has led to Canadian successes, such as that of aluminum industry and the central office switch industry. Government, the other indirect determinant of competitive advantage, has had a detrimental effect on Canadian competitiveness. As Porter puts it:

Traditionally, Canadian governments have exhibited a paternalistic outlook in their management of the economy, often seeking to insulate the Canadian economy from international competition through such mechanisms as high tariffs, subsidies, government ownership, and other interventionist policies. Government has been a protector, an agent of economic development, and a generous provider of goods and benefits. Only infrequently has government in Canada aggressively pressed firms to innovate, upgrade competitive advantage and meet high standards (p.44).

Such government policy and Canada's wealth of natural resources have led to what Porter calls the Old Economic Order in which

The aspects of this old order are interrelated and internally consistent. Reliance on basic factors has led to limited factor creation. Firm strategies and government policies have tended to reinforce this reliance, limit the sophistication of Canadian demand, and reduce the degree of rivalry in the domestic market. This, in turn, has hindered the development of world-class related and supporting industries. (p. 45)

The old order produced an economy whose prosperity and stability masked inefficiencies and significant losses in potential wealth. Each year the inefficiencies become magnified because of increased pressure from innovating firms abroad.

D. Recommendations

Since it is firms that compete, policy must be geared to making them more competitive. As noted above, competitiveness is determined by the weakest link in the diamond of national competitive advantage. An industry that relies on skilled workers will not be competitive if these workers are not available. Much policy, according to Porter, must be broadly based; he lists seven "overarching imperatives." The economy must:

1. become innovation-driven;
2. increase the sophistication of the natural resource sector;
3. tackle barriers to upgrading throughout the economy;
4. build on Canada's regional strengths;
5. move quickly and decisively to achieve complete free trade within Canada;
6. transform foreign subsidiaries into home bases; and
7. create and maintain a supportive and stable macroeconomic climate.

Most of these imperatives are self-explanatory. Two need discussion. Number 4, which seems platitudinous, is actually at odds with prevailing regional policy. Porter discovered that competitive firms and industries tend to be located in clusters. There may be, in other words, a spatial dimension to competition that could be very important to Canada, whose population is stretched out along the border with the U.S. Current regional economic policies may counter any tendency for clusters to develop. Instead of diversifying activity throughout Canada, Porter would have policy consistent with a region's comparative advantage, so that clusters would develop naturally in the regions.



Number 6 on Porter's list is motivated by the large number of branch plants in Canada. If these plants exist merely to serve the Canadian market, they will relocate if productivity here is outmatched by productivity somewhere else that can also serve the Canadian market. The solution, or imperative, according to Porter is to transform these inward-looking subsidiaries into outward-looking home bases that are forced to think globally. Unfortunately, Porter does not map out exactly how this transformation is to be accomplished. The foreign owners might try to transform their firms into innovative, competitive firms along the lines of the Porter model, but it is difficult to see why they should locate "home bases" in a foreign country (Canada) unless that country offered relative advantages over any other country. (The Porter study in general is weak on how all the necessary changes are to be accomplished.)

Porter goes on to list many more specific recommendations aimed at companies, governments and labour. A third of the almost 30 recommendations emphasise education and training; this is familiar ground -- it would be difficult to find any study of competitiveness in any country that did not do so. But Porter's message is that it is not enough to focus on only one point of the diamond of national competitive advantage.

All Porter's recommendations might be reduced to one: all Canadians must change their attitude toward competitiveness and learn to foster innovation. The old economic order is a thing of the past, no longer a possibility for the future. Canada's continued prosperity depends on the success of Canadian firms, which must innovate or perish.

E. Porter and Other Studies of Canadian Competitiveness

The immediate public reaction to his analysis of competitiveness in Canada was that Porter had merely reinvented the wheel and had provided nothing new. There may be some truth in the claim that Porter has gone over familiar ground, but in an important sense he has provided something new: a consistent and interdependent framework that allows comparison of competitive forces in Canada and in other developed economies.



It is natural, of course, that Porter would go over much of the same ground as any other study of Canadian competitiveness. The natural resource base of the Canadian economy has been studied for decades, and since the early 1980s there has been much concern over (and scrutiny of) the sharp decline in productivity that began in the mid-'70s. Previous concerns about productivity are directly related to current concerns about competitiveness. Studies dealing with either set of concerns overlap; most come up with one or more of the following solutions:

Education,
Research and Development,
Investment and Saving, and
Entrepreneurship.

The following is a representative list of related studies by individuals and organizations in Canada.

- (1) Gerald Stuber, "The Slowdown in Productivity Growth in the 1975-83 Period: A Survey of Possible Explanations," Bank of Canada, Technical Report No. 43, October 1986.
- (2) National Advisory Board on Science and Technology (NABST), *Science and Technology, Innovation and National Prosperity: The Need for Canada to Change Course*, Ottawa, April 1991.
- (3) C. E. Ritchie, "Canada in a Competitive World: Challenges and Solutions," The Bank of Nova Scotia, Halifax, Nova Scotia, 1991. This paper is representative of work produced by several Canadian banks on various aspects of competitiveness.
- (4) Canadian Labour Market and Productivity Centre, *Quarterly Labour Market and Productivity Review*, various issues. In addition to providing data on a regular basis, the Review also includes feature articles on relevant topics.
- (5) Donald J. Daly, "Canada's International Competitiveness," in Alan M. Rugman, ed., *International Business in Canada: Strategies for Management*, Prentice-Hall Canada, Scarborough, Ontario, 1989. Professor Daly has produced much work in this area, including research on the effects of exchange rate movements on Canadian competitiveness.



- (6) Economic Council of Canada, various publications. The Council's Annual Reports provide a useful discussion of the state of the Canadian economy and current economic policy; as well, the Council produces many studies and reports dealing with productivity and competitiveness.
- (7) Alan M. Rugman and Joseph R. D'Cruz, *Fast Forward: Improving Canada's International Competitiveness*. Kodak Canada Inc., Toronto, 1991.

This list could be greatly expanded with work coming out of think tanks, and economics departments and business schools at Canadian universities. Porter's study will undoubtedly lead to more work that extends or criticizes his approach.

In their study, Rugman and D'Cruz set out to "extend Porter's 'diamond' analysis in a new direction in order to make it relevant for Canada's special situation as a resource-rich nation with extensive foreign ownership." Their extension, based on Porter's 1990 book, is not the same as Porter's own extension of his model to Canada in 1991.

The report of the National Advisory Board on Science and Technology contrasts the "exploitive" past, which relied on natural resources, with the "innovative" future. Like other studies, the report emphasized research and development, education and innovation. In fact, education, broadly defined, is emerging as the single most important solution to any problems with competitiveness.

But important as education is, important as research and development is, they will not produce competitive industry in Canada if inward-looking firms continue to expend all their effort in trying to maintain the barriers to competition from which they benefit. If the route to maximum profits is lobbying in Ottawa rather than redesigning a product, the top jobs in business will go to lawyers rather than engineers. Better schools and more government-sponsored research and development may indeed lower some of a firm's costs, but the resulting increase in profits will probably accrue to the lawyers or to workers in the form of higher wage settlements than could be offered by a competitive firm. Consumers do not gain in this type of economy, as they continue to pay higher-than-competitive prices, and they do not develop into demanding buyers. Innovation does not take place. The improved education and greater R & D do not make Canadian firms more competitive in the world.



This truth can be seen from cases where policies aimed at increasing rivalry among firms were thwarted by a lack of the skilled workers needed to pursue innovation. An advantage of the Porter model is that it forces policy makers to take a broad look at the economy, hunting out the weak links in the competitive diamond, but not concentrating on any one link at the expense of the others.

THE PROSPERITY INITIATIVE

Less than a week after the release of Professor Porter's study on competitiveness in Canada, the government issued two consultation papers dealing with similar issues. The timing was unfortunate, not only because of the overlap of subject matter but also because, unlike the Porter study, the consultation papers were written to promote discussion rather than provide a blueprint for action. This discussion -- led by a private-sector steering group and including national, regional and local groups -- is expected to culminate in a plan of action, a Prosperity Initiative, by the end of summer 1992.

The two papers, "Prosperity Through Competitiveness" and "Living Well... Learning Well," were also the result of a consultative process. They reflect views expressed by "more than 60 business, labour, academic and social action groups, as well as of provincial governments." This section will outline the major topics addressed by the two documents. Many of this paper's comments on the Porter study -- especially the relationship between that study and previous work on competitiveness -- hold for the consultation papers and therefore need not be repeated. The discussion below concentrates on the contents of the government documents.

A. "Prosperity Through Competitiveness"

The first paper, "Prosperity Through Competitiveness," excludes direct analysis of exchange rates, interest rates and the deficit. Instead, it focuses on learning, innovation, financing, domestic



markets, trade and partnerships. These are familiar focal points -- see the discussion above of Porter and other studies of Canadian competitiveness. They are keyed to the global economy, where, according to more familiar analysis, the performance of the Canadian economy lags behind that of its competitors.

To say that "Prosperity Through Competitiveness" covers the same ground as Porter's study is not to condemn it. Both consultation papers of the Prosperity Initiative are generous in their citations of past studies and quotations from individuals in business, labour and government. The strength of the two papers lies in their consolidation of past views of competition in Canada into 28 Issues for Discussion.

Learning is at the centre of the first paper (and the second discussion paper focuses exclusively on it). The concept of learning used is broad, encompassing the base for new technology as well as development of skilled workers. The time span of learning is also broad. Canadians at present think of education as something that takes place early in life. This, according to the consultation papers, is an outmoded view that has led to a divorce between school and work. What is needed is a new view that recognizes that learning is a lifelong activity; in a fiercely competitive world, training must be a continuous process.

Part of continuous learning, of course, is becoming aware of problems as they develop. The 28 Issues for Discussion are scattered throughout the paper "Prosperity Through Competitiveness" and are placed in the context of perceived problems. The following are examples of the Issues for Discussion.

What government-controlled constraints remain on private sector R & D investments and the diffusion of technology? (p. 18)

What steps should be taken to reduce the apparent knowledge gap between financial institutions and their business customers? (p. 22)

How can the cost of regulatory overlap [federal and provincial regulation of financial institutions] best be minimized? (p. 23)



In the text leading to another Issue for Discussion the paper states: "Ongoing dialogue is needed among individuals, unions, firms and governments to ensure that we explore all options and engage the private sector fully in program design and delivery." The consultation papers' emphasis on dialogue and consensus, however, masks the many conflicts that must be resolved if Canada is to compete in the world. Some of the conflict stems from the inability of many to see that globalization is forcing change on Canada; the debate should be on the form this change will take, not on whether it can be avoided.

Change implies adjustment costs. And these costs will not be evenly distributed. Those that bear the heaviest cost will become powerful pressure groups, and the dialogue generated by the consultation papers will not be dispassionate, nor will it necessarily be about the best way to become competitive. The apparent consensus that emerges from a forum on competitiveness may be on the best way to minimize adjustment costs or to shift them to groups with little political power. The Prosperity Initiative put forward in 1992 may be unable to resolve painful conflicts.

B. "Learning Well... Living Well"

Education, though everyone's concern, is a provincial responsibility under the Constitution. The second government paper recognizes the provinces' jurisdictional responsibility and proposes to extend this provincial jurisdiction to include training. This would be a step toward governmental cooperation in the efficient provision of services in Canada. The proposal to consolidate responsibility for education and training is also consistent with the consultation papers' view that links must be forged between education and competitiveness and that education and training must be constantly upgraded by all Canadians.

The paper "Learning Well... Living Well" provides a good discussion of why Canadians must change their attitudes to education. As is the case for competitiveness in general, the world has changed; thus our system for providing education and training must also change. The

paper does not limit itself to issues for discussion, but ends with some general questions. Many of these questions deal with targets: Should we have educational targets? What should they be? What should be the federal government's role in setting them?

THE IMPORTANCE OF HOW? AND WHY?

Both the Porter study and the Prosperity Initiative have been criticized for not dealing with specifics -- that is, for not explaining exactly how Canadians are to become more competitive. Suggestions for changing attitudes and reaching a consensus on the important issues, while important, are not sufficiently concrete. Policies aimed at them could easily lose sight of the very individuals, those investing in R & D or those opting for retraining, whose attitudes must be changed. After a round of consultations, 80% of Canadians may be convinced that increased investment in R & D is necessary; but if the unconvinced 20% include those responsible for investment, R & D will not increase.

That example leads to an important question that has not been adequately probed: if increased R & D would improve productivity and competitiveness, why haven't Canadian firms already increased their investment in R & D? We can ask similar questions about most suggestions for improving competitiveness. Why, if on-the-job training...? Why, if greater cooperation with labour...? Why, if product innovation...?

There are two possible answers to these sets of questions. The first is that the individuals who make the decisions about investment and training do not have adequate information. According to this line of reasoning, if the decision-makers had better information about (say) the effects of training on competitiveness, they would immediately increase training. Imperfect information, which can be a lack of information or an uneven distribution of information, has long been one rationale for government intervention in the market. With respect to attempted improvements in competitiveness, the government must ask whether it can really overcome any imperfections of information. The government must be



frank and admit that the costs of its intervention may far outweigh the benefits.

The other possible answer to our set of questions is that present incentives do not lead to more investment and training because alternative action (or inaction) is more profitable. The incentives now in place may lead corporate executives to spend more time lobbying in Ottawa for a change in legislation than worrying about technology and what they produce. Current incentives, broadly defined to include all influences on students and teachers, may also lead elementary and secondary school students away from the study of mathematics and science; if this happens, of course, university enrolment in engineering and the sciences may fall.

Before anyone can explain exactly how Canadian competitiveness can be improved, it is necessary to know the reasons for current courses of action; that is, what incentives are now in place and how workers and business executives react to them. Such information would be a useful complement to the two consultation papers and the Porter study discussed in this paper.



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